FAIR VALUE ACCOUNTING – PROS AND CONS

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Abstract

Fair value accounting continues to be a topic of significant interest and debate among the preparers and users of financial information. Fair value continues to be an important measurement basis in financial reporting. It provides information about what an entity might realize if it sold an asset or might pay to transfer a liability. In recent years, the use of fair value as a measurement basis for financial reporting has been expanded, even as the debate over its usefulness to stakeholders continues. Determining fair value often requires a variety of assumptions, as well as significant judgment. Thus, investors desire timely and transparent information about how fair value is measured, its impact on current financial statements, and its potential to impact future periods. There are numerous items for which fair value measurements are required or permitted. ASC 820 and IFRS 13 ("the fair value standards") provide authoritative guidance on fair value measurement.

The increased use of fair value requires companies to refresh measurement policies and procedures. Companies should analyze how fair value is determined when no active market exists, and establish procedures to develop the appropriate disclosures. Valuation professionals may need to be involved early in the process.

Appropriate and robust disclosures in the financial statements are necessary to inform investors about measurement methods and uncertainty. The increasing needs for disclosures may require the establishment new processes and databases to record and report the information.

Key words: fair value, accounting, measurement, policiesdisclosure

1. Introduction

The recent financial crisis has turned the spotlight on fair-value accounting and led to a major policy debate. Critics argue that fair-value accounting, often also called mark-to-market accounting, has significantly contributed to the financial crisis and exacerbated its severity for financial institutions in the US and around the world. On the other extreme, proponents of fair-value accounting like Turner (2008) and Veron (2008) argue that it merely played the role of the proverbial messenger that is now being shot. In our view, there are problems with both positions. Fair-value accounting is neither responsible for the crisis nor is it merely a measurement system that reports asset values without having economic effects of its own.

Fair value measurement has been a controversial topic in the United States and elsewhere for more than a century. Advances in finance and accounting research, and much discussion, have not reconciled the conflicting perspectives of supporters and critics of using fair value measurement in financial statements. Indeed, after more than twenty years of research documenting the decision usefulness of disclosures about the fair values of financial instruments, standard setters are contemplating abolishing these disclosures for private companies. The 2008 financial crisis increased public scrutiny and brought accounting measurement to the forefront of policy debate, including debate characterized by polarizing rhetoric.

With regard to empirical evidence on this issue, and despite some commentators' belief that accounting measurement, specifically measuring certain financial assets at fair value, contributed to the 2008 economic crisis, to date no published empirical research documents a clear causal relation between the fair value measurement attribute and systemic risk. Instead, research suggests that holdings of certain financial instruments, business models, and regulatory practices have a firstorder effect on systemic risk [1]. Accounting may have second-order effects, but research suggests that these primarily are the result of delayed loss recognition on financial assets measured at amortized cost subject to impairment and gains trading involving assets measured at amortized cost, for purposes of income recognition.

The fair value standards define how fair value should be determined for financial reporting purposes. They establish a fair value framework applicable to all fair value measurements under U.S. GAAP and IFRS (except those measurements specifically exempted). The fair value standards require that fair value be measured based on an "exit price" (not the transaction price or entry price) determined using several key concepts [2]. Preparers need to understand these concepts and their interaction. They include the unit of account, principal (or most advantageous) market, the highest and best use for nonfinancial assets, the use and weighting of multiple valuation techniques, and the fair value hierarchy. Preparers also need to understand valuation theory to ensure that fair value measurements comply with the accounting standards

1. Fair value and its measurement

Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of the liabilities. Under fair value accounting, companies report losses when the fair values of their assets decrease or liabilities increase. Those losses reduce companies' reported equity and may also reduce companies' reported net income.

Although fair values have played a role in U.S. generally accepted accounting principles (GAAP) for more than 50 years, accounting standards that require or permit fair value accounting have increased considerably in number and significance in recent years.

The goal of fair value measurement is firms to estimate as best as possible the prices at which the positions they currently hold would change hands in orderly transactions, based on current information and conditions. To meet this goal, firms must fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements. When market prices for the same or similar positions are available, the fair value standards generally require firms to use these prices in estimating fair values. The rationale for this requirement is market prices should reflect all publicly available information about future cash flows, including investors' private information that is revealed through their trading, as well as current risk-adjusted discount rates. When fair values are estimated using unadjusted or adjusted market prices, they are referred to as mark-to-market values. If market prices for the same or similar positions are not available, then firms must estimate fair values using valuation models. IFRS generally requires these models to be applied using observable market inputs (such as interest rates and yield curves that are observable at commonly quoted intervals) when they are available and unobservable firm-supplied inputs (such as expected cash flows developed using the firm's own data) otherwise. When fair values are estimated using valuation models, they are referred to as mark-to-model values [3].

The European Commission has endorsed IFRS 13, Fair Value Measurement, which sets out a single framework for measuring fair value and provides comprehensive guidance on how to measure it. IFRS 13 is the result of a joint project conducted by the IASB together with FASB, which led to the same definition of fair value as well as an alignment of measurement and disclosure requirements to FAS 157. Both FAS 157 and IFRS 13 define fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. This definition of fair value reflects an exit price option, which is the market price from the perspective of a market participant who holds the asset. Moreover, fair value must be a market-based, not an entity-specific measurement, and the firm's intention to hold an asset is completely irrelevant. For instance, the application of a blockage factor to a large position of identical financial assets is prohibited given that a decision to sell at a less advantageous price because an entire holding, rather than each instrument individually, is sold represents a factor which is specific to the firm. If observable market transactions or market information are not directly observable, the objective of fair value measurement still remains the same, that is to estimate an exit price for the asset, and the firm shall use valuation techniques [4] .

Fair value accounting is the practice of accounting that values certain assets and liabilities at their current market value, and it seeks to capture and report the present value of future cash flows associated with an asset or a liability. IAS 39 establishes the principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This standard includes provisions about the classification of financial instruments, when financial instruments should be recognised and derecognised. In financial statements fair values are used in the three circumstances:

- to measure some assets and liabilities at each balance sheet date;
- to measure some assets and liabilities on their initial recognition in the financial statements or on transition from national to IFRS; and
- to determine some asset impairments.

Only the first of these conditions should be described as fair value accounting. IFRS require measurement at fair value at each balance sheet date and the recognition of unrealised gains, in other words, fair value accounting only for derivatives, equity investments, investments in debt securities, other financial assets and financial liabilities that are held for trading, some non-financial liabilities (provisions), and some biological assets. IFRS allow, but does not require, measurement at fair value at each balance sheet date and the recognition of unrealised gains for investment property, property, plant and equipment, intangible assets, and financial assets or liabilities that otherwise would be measured at amortised cost [5]. Overall, the objective of fair value measurement is to determine the price at which a transaction would take place. Because prices quoted in active markets are preferable to other valuation methods, this type of accounting essentially might enhance the transparency of financial data in volatile times. The reliability of fair value depends on the inputs in the measurement procedure.

An ordinary method of valuation for assets is the discounted cash flow (DCF), but the reliability of this valuation technique is questionable, because it uses forecasting. However, DCF is generally used in measuring fair value for intangible and long-lived assets, and fair value information is more preferable for liquid assets, such as marketable securities. Estimating future cash flows always carries risk and fair value for long-term and intangible assets is even more subjective and less reliable, even if other techniques were used [6].

To grab the difficulty in measuring risk, we could consider some of the valuation problems for debt securities backed by subprime mortgages. The uncertainty in measuring risk illustrates the difficulty in making accurate predictions for purposes of fair value. The current pressure on corporate cash flows means that liquidity risk is likely to be a material risk for many firms. Because of the lack of market information and uncertainty in recent months European companies are facing challenges, and therefore in October 2008 the IASB has issued a draft report to provide useful information and educational guidance for measuring and disclosing fair values. Besides dealing with increased liquidity risk, the other major outcome of these off-putting changes is expected to be about going concern assumption. If this concept is not applicable there will often be a material and negative impact on the financial statements. It is the governing body or the management that is required to make an assumption about whether or not the enterprise is a going concern for the foreseeable future when it prepares its financial statements.

2. Accounting and financial reporting topics impacted by the fair value standards

The fair value standards apply in all circumstances where accounting pronouncements require or permit fair value measurements, measurements based on fair value (such as fair value less costs to sell), and disclosures about fair value measurements, with limited exceptions, as specified [3]. Significant accounting standards affected by the fair value standards include the following:

Table 1 - *Significant items that call for the use of fair value in accordance with ASC 820, excluding industry specific topics*

Asset retirement and environmental obligations (ASC 410)	**Financial assets/liabilities eligible for fair value option (ASC 825-10)**	**Distinguishing liabilities from equity (ASC 480)**
Business combinations (ASC 805)	Financial instruments (ASC 825)	Property, plant, and equipment (ASC 360)
Debt and equity investments (ASC 320)	Goodwill and intangibles (ASC 350)	Stock compensation (ASC 718)
Derivatives (ASC 815)	Guarantees (ASC 460)	Nonmonetary transactions (ASC 845)
Employee benefits (ASC 715 and ASC 960)	Hybrid financial instruments (ASC 815-15)	Transfers and servicing (ASC 860)
Exit and disposal costs (ASC 420)	Troubled debt restructurings (ASC 470-60)	

Table 2 - *Significant items that call for the use of fair value in accordance with IFRS 13*

Business combination—assets acquired and liabilities assumed (IFRS 3)	**Employee benefits—postemployment benefit obligations (IAS 19)**	**Intangible assets—revaluation model (IAS 38)**
Financial instruments: recognition and measurement—assets/liabilities eligible for fair value option (IAS 39)	Investments in associates and joint ventures—held by mutual funds and similar entities (IAS 28)	Property, plant and equipment—revaluation model and exchange of assets (IAS 16)
Noncurrent assets held for sale and discontinued operations (IFRS 5)	Business combinations—contingent consideration (IFRS 3)	Financial instruments: recognition and measurement—derivatives (IAS 39)
Business combinations—noncontrolling interests in an acquiree (IFRS 3)	Business combinations—previously held interest (IFRS 3)	Financial instruments: presentation—hybrid financial instruments (IAS 32)

Revenue (IAS 18)	Financial instruments: recognition and measurement—financial guarantee contracts (IAS 39)	Consolidated financial statements—investments in subsidiaries by investment entities (IFRS 10)
Financial instruments: recognition and measurement—debt and equity investments (IFRS 9 and IAS 39)		

As illustrated by the figures above, there are numerous accounting and financial reporting topics impacted by the fair value standards.

3. Fair value accounting pros end cons

As with any accounting method, there are several advantages and disadvantages that must be considered before adopting the fair value accounting [7].

3.1. Pros of fair value accounting

- *Timely information*

Since fair value accounting utilizes information specific for the time and current market conditions, it attempts to provide the most relevant estimates possible. It has a great informative value for a firm itself and encourages prompt corrective actions.

- *It provides an accurate valuation*

This method of accounting helps to provide more accuracy when it comes to current valuations from assets and liabilities. If prices are expected to increase or decrease, then the valuation can do the same. If sales occur, then there aren't discrepancies that must be charted if the valuation differ from the transaction. The current market prices allow individuals or businesses to know exactly where they stand.

- *More information in the financial statements than historical cost*

Fair value accounting enhances the informative power of a financial statement as opposed to the other accounting method - the historical cost. Fair value accounting requires a firm to disclose extensive information about the methodology used, the assumption made, risk exposure, related sensitivities and other issues that result in a thorough financial statement. Inclusion of more information is possible whenever there are [4]:

- observable market prices that managers cannot materially influence due to less than perfect market liquidity;
- Independently observable, accurate estimates of liquid market prices.

This way produced financial statements therefore increase transparency of a firm, which is particularly useful to potential investors, contractors and lenders, as they have a better perception of the stability of a given firm and insight into its.

- *It provides a measurement of true income*

There is less of an opportunity to manipulate accounting data using the fair value approach. Instead of using the sale of assets to affect gains or losses, the price changes are simply tracked based on the actual or estimated value. The changes to income happen with the changes to the asset value, reflected in the final net income numbers.

- *It is the most agreed upon standard of accounting*

Instead of the historical cost value that isn't always accurate after a long period of time, fair value accounting accurately tracks all types of assets, from equipment to buildings to even land. This makes it the most agreed upon standard of accounting because set prices, even if still accurate in value, aren't the same because of monetary inflation. $10 today is not worth the same $10 from 2001. That's why fair value can be so beneficial.

- *It provides a method of survival in a difficult economy*

In the historical method, the same value goes of an asset goes on the budget line every year. When there's a difficult economy and prices are reduced, this can become a cumbersome financial burden. Fair value accounting allows for asset reductions within that market, so that a business can have a fighting chance.

3.2. The cons of fair value accounting

- *It can create large swings of value that happen several times during the year*

There are some businesses that do not benefit from this method of accounting at all. These businesses typically have assets that fluctuate in value in large amounts frequently throughout the year. Volatile assets can report changes in income that aren't actually accurate to the long-term financial picture, creating misleading gains or losses in the short-term picture.

- *Misery typically loves company*

If one business is seeing a reduction in net income thanks to asset losses, then this trend typically creates a domino effect throughout a region or an industry. Downward valuations are contagious and often trigger selling that is unnecessary because of the volatility of the market. When this method of accounting isn't used and downward valuations don't have to happen, there is more investor stability that can, in turn, keep a region or industry's overall economics stable as well.

- *It reduces investor satisfaction*

Some investors don't always notice that a company is using the fair value approach to accounting. This creates investor dissatisfaction because the loss of value in the net income becomes an income loss for the investors as well. Since many investors are trading these commodities instead of using them for an investment, it can create a tough hit for their portfolio and cause many investors to stay away from the business altogether.

- *Misleading Information*

It is possible that sometimes the observed value of an asset in the market is not indicative of the asset's fundamental value. Market might be inefficient and not reflect in its estimates all publicly available information. There are also other factors that could cause that this market estimate to be deviated such as investor irrationality, behavioural bias or problems with arbitrage among others. Ball (2006) also points out that market liquidity is a potentially important issue because spreads can be large enough to cause substantial uncertainty about fair value and hence introduce large overall value deviations ("noise") in the financial statements.

- *Manipulation*

Manipulation of the price by the firms themselves also presents a risk in obtaining a fair value estimates, because in illiquid markets, trading by firms can have an effect on both traded and quoted prices.

- *It loses the historical perspective*

Although current accounting is important to measure, there must also be a general sense of what has happened historically for accuracy in tracking results [8]. Because assets may have a down year and reduce net profits, it can artificially lower the successes that a business may have had. For example, if a small business has assets of $100,000 that suddenly become valued at $60,000 due to market losses and there were $50,000 worth of net profits outside of the asset reduction, the company's net profits would actually be just $10,000.

- *Contribution to the procyclicality of the Financial System*

Following the recent financial crisis, there has been a debate about the potential contribution of fair value accounting. Many believe that it exacerbated the effects of the crisis, through increasing the inherent procyclicality of the financial system. (Procyclicality refers to the ability to exaggerate financial or economic fluctuations.) Fair value accounting and its dependency on the development of the market situation could cause that a market that experiences a slump is closely followed by a deterioration of a firm's financial situation that in turn causes the market to panic, bringing it closer to an outbreak of a crisis. Since financial institutions are closely related to firms and the business cycle in general, if fair values indicate a fall, losses will also be reflected on the banks´ capital [9].

The fair value accounting pros and cons show that for the most part, businesses can have a transparent and accurate method of tracking profit and loss. As long as investors are kept in the loop and know what is going on, the benefits will typically outweigh the risks in this matter.

5. Conclusion

Historical cost provides investors with the cost of the investment, while fair value gives a measure of what the management expect to get in return from a certain investment. Knowledge of fair value is important, although it is not enough. Users also need to know the cost of the investment. In fact, knowing how much resources have been sacrificed to obtain that fair value, they could effectively evaluate stewardship.

According to the advantages and disadvantages of the concept of fair value in accounting, it is quite obvious and clear that this concept is far from being perfect. It is very difficult to determine whether its contribution to the improvement of accounting is really beneficial. On the one hand there are many reasons why the users of this method are better off, but on the other hand there are also several reasons why they are worse off. In fact, many of relevant sources express their mixed views about the extent to which IFRS are becoming imbued with the current IASB/FASB fascination with fair value accounting. Although the fair-value discussion seems to be far from over now, the current crisis provided an interesting setting to further explore these issues, understand them better and hopefully urge responsible institutions to fix the imperfections within the system to make it work correctly and more effectively.

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